
***Promoting a Positive Mortgage
Insurance Environment
for New Rental Construction***

Prepared For:

**Research Subcommittee
Housing Supply Working Group**

Ontario Ministry of Municipal Affairs and Housing

By:

**Greg Lampert
and
Steve Pomeroy**

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Executive Summary

This report has been prepared on behalf of the Research Subcommittee of the Housing Supply Working Group (HSWG) – a joint government-industry advisory group established to identify rental housing supply problems and solutions. The HSWG is co-chaired by the Ontario Ministry of Municipal Affairs and Housing and industry representatives.

In May 2001, the HSWG released an interim report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply*, which called for action to encourage much-needed new rental investment. Among other things, the report recommended examination of the mortgage insurance practices of Canada Mortgage and Housing Corporation (CMHC) with respect to new rental housing (e.g. insurance fees for high-ratio loans and the determination of lending value for rental housing) and the feasibility of the Province facilitating the provision of mortgage insurance for rental housing construction – either directly or in partnership with CMHC.

This report is one of three companion reports intended to address issues raised in the HSWG interim report and are background reports for the HSWG's second report: *Creating a Positive Climate for Rental Housing Development Through Tax and Mortgage Insurance Reforms*. The three reports include:

1. **Options for Changes in Federal Taxes to Encourage New Rental Construction** – development of a framework for the identification and analysis of potential changes to the federal tax system that would strategically improve the climate for new rental investment in Ontario;
2. **The Context for Private Rental Housing Production in the US** – identification of the most significant tax and housing-related program levers impacting new market rental development in the US, how they work, how they generate capital for new market rental housing, and the potential for using such mechanisms in Canada; and
3. **Promoting a Positive Mortgage Insurance Environment for New Rental Construction** – examination of CMHC's underwriting practices and mortgage insurance fees for rental housing, and identification of options for the Province to promote improved access to mortgage insurance for new rental housing projects – this report.

This report examines CMHC's mortgage insurance premium structure and related underwriting criteria – both those which applied in the past, and the recent changes. In addition, it investigates rental lending practices in the US, and explores possible alternatives whereby the Province might assist in promoting improved access to financing for rental projects.

Mortgage insurance is a key element in securing financing for new rental development. Key industry stakeholders, including lenders and potential investors, view CMHC mortgage insurance with mixed feelings. On the one hand, CMHC insurance provides access to high-ratio financing, lower interest rates and greater leverage than would otherwise be possible. On the other hand, the process and associated negotiations are seen as unnecessarily difficult and uncertain. Stakeholders would like to see a more streamlined process with a greater degree of flexibility in CMHC's underwriting practices – and lower fees.

In the absence of the actuarial analyses behind CMHC's mortgage insurance fees and underwriting criteria, it is not possible to provide comment on whether these are reasonable, given the (substantial) risks associated with loans on new rental housing projects. CMHC has a mandate to provide mortgage insurance 'on a commercial basis' so the fees and other requirements no doubt reflect this. However, according to stakeholders, the larger issue is one of appropriate public policy and CMHC's other mandate to facilitate the effective functioning of the housing market – including the rental housing sector. Stakeholders question why CMHC's mortgage insurance function should be retained in a publicly-owned corporation if its commercial mandate means it is restrained from facilitating the financing of new rental housing – a clear public policy goal of the federal government.

CMHC has responded to criticism of its mortgage insurance underwriting criteria and fees by introducing changes effective in March 2002. CMHC has reduced the fees for 85% LTV (loan to value ratio) mortgages slightly (from 5% to 4.5%), while fees for 71%-80% LTV mortgages are higher. There are also substantial changes to CMHC's underwriting practices with respect to loans for new rental housing – through the use of 'market-derived' capitalization (cap) rates and modifications in the required debt coverage ratios (DCRs) for new rental loans.

The adoption of a market cap rate is a significant improvement from the previous 'official' policy of using a minimum 9% cap rate. However, the changes in the minimum DCR requirements threaten to undermine the effect of using market cap rates in strong rental markets (with low cap rates) such as Toronto and Ottawa – and will actually reduce the volume of financing available for new rental projects below previous levels if (as expected) mortgage interest rates rise from their current very low levels. At present, if rental investors attempt to 'lock-in' interest rates for when a project is completed, the new DCR requirements may restrict the size of the mortgage to less than what would be available using the previous underwriting criteria.

The system for financing new rental investment in the US provides useful insights for Canada. In the US, mortgage insurance is not available for most private rental projects. Risk is managed and reflected largely in the form of higher interest rate spreads over long-term government securities than are common in Canada with insured loans. Most rental project financing is facilitated and influenced by a much larger and more sophisticated secondary mortgage market.

In the main, US rental developers cannot secure greater than 80% LTV loans and typically lenders require DCRs similar to those recently introduced by CMHC. The major difference in the US is that most loans are non-recourse – i.e. personal covenants and guarantees (required for CMHC-insured loans) are not typically required in the US.

If the Province considers that the recent changes in CMHC's mortgage insurance practices are not sufficient to facilitate access to mortgage financing for rental development, a number of options are available:

- Continue to press for more flexible financing terms for rental development;
- Partner with the federal government to provide improved service (by sharing risk);
- Form a Provincial mortgage insurance operation; or
- Explore private sector partnering alternatives to CMHC mortgage insurance.

Of these options, the first two appear most feasible.

Pressing for more flexible financing terms for rental development could take several avenues:

- **Analysis of the risks of rental mortgages** – without access to CMHC's actuarial analysis, it is not possible to undertake a comprehensive assessment in this area. However, a review of the package of risk mitigation measures employed by CMHC (substantial mortgage insurance fees, strict underwriting criteria, rental achievement holdbacks, and guarantees from investors) suggests that there may be a case for some flexibility whereby, if CMHC has adequate security (e.g. the project itself and 'iron-clad' guarantees), perhaps some of the other risk mitigation measures (e.g. DCR or fees) might be relaxed to some extent.
- **CMHC's mandate** – stakeholders question why CMHC's mortgage insurance functions should be retained in a crown corporation if the Corporation is unable to promote the broader public policy goal of facilitating rental investment by taking on more risk. Given the evident profitability of CMHC's mortgage insurance operations, and the lack of new CMHC-insured rental housing loans, there would seem to be some room to manoeuvre by taking greater risks on rental mortgage insurance.
- **The Bank Act** – at present, federally chartered lenders are not allowed to make property loans in excess of 75% of property value without mortgage insurance. With no competition, this means that CMHC is the only option available for borrowers seeking high-ratio loans. In the US, lenders regularly provide financing equivalent to 80% of property value without mortgage insurance. It may be time to revisit this requirement and allow lenders to take on the additional risk associated with high-ratio loans without requiring mortgage insurance. This would permit the market to price risk and would provide an alternative risk assessment to that undertaken by CMHC.

Alternatively, the Province could negotiate a risk-sharing partnership with the federal government to facilitate improved access to mortgage insurance for new rental projects. The partnership could utilize CMHC's existing underwriting infrastructure and expertise to provide a sound basis for the risk assessment of rental projects but, at the same time, create the opportunities for additional flexibility on maximum loan levels and/or lower fees – through Provincial guarantees.

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1. Introduction

This report has been prepared on behalf of the Research Subcommittee of the Housing Supply Working Group (HSWG) – a joint government-industry advisory group established to identify rental housing supply problems and solutions. The HSWG is co-chaired by the Ontario Ministry of Municipal Affairs and Housing and industry representatives.

In May 2001, the HSWG released a report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply*, which identified various actions which could assist in stimulating new rental investment. The report indicated that access to financing was a critical factor in encouraging new rental development. Recommendation 2 (of 12 recommendations contained in the report) states:

- 2a It is recommended that the Province and industry work with the federal government to identify changes to CMHC lending practices which would encourage rental development. This would include reviewing insurance fees for high ratio loans for rental housing and the determination of lending value for rental housing.
- 2b It is further recommended that, in the absence of federal government action to address the current disincentives with respect to CMHC mortgage insurance, research be undertaken to determine the feasibility of the Province providing mortgage insurance for rental housing construction, directly or underwriting CMHC mortgage insurance.

This report responds to these recommendations by examining CMHC's underwriting practices and mortgage insurance fees for rental housing and identifying options for the Province to promote improved access to mortgage insurance for new rental housing developments.

In addition to this introduction, the report includes the following sections:

- 2. **The Importance of Mortgage Insurance in Financing New Rental Housing** – an examination of the key role of mortgage insurance in financing new rental housing projects.
- 3. **Changes in CMHC Mortgage Insurance Practices** – a review of the changes in CMHC's underwriting criteria and mortgage insurance fees since 1995, including the recent changes which became effective in March 2002.
- 4. **Stakeholder Comments on CMHC Mortgage Insurance Practices** – the views of developers and mortgage finance experts with respect to potential changes in CMHC's underwriting practices which could improve the economics of investment in new rental housing projects.
- 5. **Financing Rental Housing in the US** – a review of mortgage financing and the role of mortgage insurance for new rental housing in the US.
- 6. **Options for the Province to Facilitate Financing for New Rental Housing** – an examination of how the Province might encourage more favourable provision of mortgage financing for new rental housing projects.
- 7. **Conclusions.**

2. *The Importance of Mortgage Insurance in Financing New Rental Housing*

Mortgage financing is a key part of new rental development. Given the large amount of capital necessary to build rental housing (e.g. in excess of \$100,000 per unit, so even a small project costs more than \$5 million), the typical approach is to borrow a large part of the capital required, because few developers have the cash necessary to cover the full cost of development. Also, when interest rates are below the return from the property, an investor can use borrowed funds to leverage return on equity to more attractive levels.

Mortgage financing, in Canada at least, is closely associated with mortgage insurance – in part, a consequence of statutory requirements. Mortgage insurance provides a form of credit enhancement for borrowers which allows lenders to offset or share the risk associated with high-ratio loans on rental housing – it helps to create a more effective marketplace for lenders and borrowers. This section reviews how mortgage insurance works, and its key role in the financing of new rental projects.

Typically, Canadian mortgage lenders are restricted to lending up to a maximum of 75% of the estimated value of real estate – called the ‘loan-to-value’ (LTV) ratio.¹ For mortgage loans with LTVs of greater than 75%, lenders typically must obtain mortgage insurance (more properly described as ‘mortgage default insurance’) which protects the lender in the event that the borrower defaults on the mortgage. At present, CMHC is the only mortgage insurance company in Canada which provides mortgage insurance on rental housing projects; the only other mortgage insurance company (GE Capital Mortgage Insurance Canada – GEMICO) does not offer mortgage insurance for rental housing.

The advantages of obtaining mortgage insurance on the financing of new rental housing projects are two-fold:

- **Larger loans (and correspondingly less equity)** – with CMHC mortgage insurance², investors can obtain mortgages on rental properties for up to 85% of property value. As a result, they can leverage a greater proportion of the cost of a project – and, therefore, reduce the amount of equity investment required.
- **Lower interest rates** – mortgage insurance effectively shifts default risk from the lender to the mortgage insurer (in this case, CMHC). Because a lender’s exposure is reduced with an insured loan, there is less need for a ‘risk premium’ and a lower mortgage rate can be charged. Also, in packaging loans for the secondary market, CMHC insurance is effectively a government of Canada guarantee. Hence, the mortgage interest rates for loans with CMHC insurance are usually much less than for conventional mortgages.

¹ The 75% LTV limit applies to federally chartered financial institutions. For lenders chartered under provincial legislation (e.g. credit unions and trust companies), there is typically no legislative restriction regarding LTV on real estate financing. However, as a general policy, these smaller financial institutions usually adopt the practice of requiring mortgage insurance on high-ratio real estate loans.

² CMHC operates under the *National Housing Act* (NHA). A mortgage insured by CMHC is correctly referred to as an NHA-insured mortgage – for simplicity here, such a mortgage is referred to as ‘CMHC-insured’.

Typically, CMHC-insured mortgages carry interest rates which are 60-80 basis points less than conventional mortgages with a similar term.

The effect of mortgage insurance on the economics of a new rental project can be demonstrated using the illustrative rental project described in the report *Options for Changes in Federal Taxes to Encourage New Rental Construction*, prepared for the HSWG by the same consulting team as this report. Details regarding the costs and revenues for the illustrative rental project are provided in Section 2 (pages 2-3) of that report – called the ‘federal tax report’ here for short.

Exhibit 2-1:

**CMHC Versus Conventional Financing
Illustrative Rental Project, Toronto**

(\$ per unit)

	CMHC Insured (Base Case)	Conventional Mortgage Financing
Development Costs and Financing		
Land	24,400	24,400
Construction	117,000	117,000
GST	<u>6,363</u>	<u>6,363</u>
Project Costs	147,763	147,763
Equity	23,763	38,351
Mortgage Financing	124,000	109,412
Mortgage Insurance Fee	<u>5,580</u>	<u>0</u>
Total Mortgage	129,580	109,412
First Year Revenues, Costs and Cash Flow		
Revenues	16,300	16,300
Maintenance & Operations	2,000	2,000
Property Taxes	<u>1,900</u>	<u>1,900</u>
Total Operating Costs	3,900	3,900
NOI	12,400	12,400
Mortgage Payments	10,415	9,400
Cash Flow	1,985	3,000
Cash-on-Cash Return	8.4%	7.8%

Exhibit 2-1 presents a review of the pro forma for the average unit in the illustrative rental project under two financing scenarios:

- **CMHC-insured mortgage financing** – this is the same as the ‘base case’ scenario in the federal tax report. It assumes an 85% LTV with the lending value based on an 8.5% cap (capitalization) rate. Cap rates are applied to NOI to determine lending value – in this case, with NOI of \$12,400, an 8.5% cap rate would result in a lending value of \$145,882

[$\$12,400/0.085$] (not shown in the exhibit).³ With an 85% LTV, the mortgage amount would be \$124,000. For 85% LTV mortgages, CMHC now charges a mortgage insurance fee of 4.5% of the value of the mortgage (\$5,580) which is added to the mortgage principal and amortized over the repayment period for the mortgage. Assuming a 6.5% mortgage interest rate amortized over 25 years, the annual payments are \$10,415 (including both principal and interest – on the full mortgage, including the mortgage insurance fee).

- **Conventional mortgage financing** – without CMHC mortgage insurance, the maximum LTV is 75%. Assuming the same cap rate (the effects of varying the cap rate are examined later), this results in a mortgage of \$109,412. There is no mortgage insurance fee; however, the mortgage interest rate is higher for conventional financing – as discussed, conventional mortgage interest rates are typically 60-80 basis points higher than the interest rates on CMHC-insured loans. With the CMHC-insured mortgage assumed to be 6.5%, a 7.25% mortgage interest rate (amortized over 25 years) is assumed in this case – a spread of 75 basis points over the CMHC-insured mortgage.

Key aspects of the differences between the two financing scenarios include:

- The equity required for conventional financing is \$14,588 per unit higher than for the 85% LTV CMHC-insured mortgage. For a 200-unit project, this difference in equity reaches almost \$3 million. In general, investors would prefer not to have to commit so much equity.⁴
- Despite the higher mortgage interest rate (7.25% versus 6.5%), the mortgage payments are less with the conventional financing because the mortgage principal is less – by over \$20,000 due to the combination of higher equity (with conventional financing) and the absence of the CMHC mortgage insurance fee (4.5%).
- Because of the lower mortgage payments, the cash flow from the project is greater with conventional financing than with CMHC financing. However, this is because of the smaller mortgage and the significantly greater equity required from the investor.
- In terms of cash-on-cash return (on equity), the CMHC-insured project would generate a greater return of 8.4%, compared to 7.8% for the conventionally-financed project. Both the greater return on equity and the much lower equity required with CMHC insurance would (all other things being equal) make CMHC insurance the more attractive option for an investor.

³ As with the federal tax report, the analysis here utilizes CMHC's recently-announced mortgage insurance premiums and assumes the use of a market cap rate of 8.5% – lower than the 'official' CMHC required minimum 9% cap rate which was in effect until March 2002.

⁴ This illustrative example has been simplified and uses only the lending value as the loan constraint. The impact of a second constraint on the maximum loan amount – the debt coverage ratio (DCR) – is not applied in this simplified case. Here, the DCR is 1.24 [NOI/mortgage payments (on the mortgage principal, excluding the mortgage insurance fee – not shown in the exhibit)]. This is above the 1.2 minimum DCR which CMHC requires for a loan with a 10-year term, but less than the 1.3 minimum DCR for loans with a 5-year term. So, if this were a 5-year term mortgage, the maximum loan amount, equity and return on equity are slightly overstated in this illustration. The effect of CMHC's DCR requirements in limiting the size of insured loans is explored in more detail later in this report.

3. Changes in CMHC Mortgage Insurance Practices

This section reviews the changes to CMHC's mortgage insurance practices with respect to rental housing over the past several years – in 1995, in 1998 (when changes were introduced for *existing* rental projects), and the recently-announced changes which were introduced in March 2002.

1995 Changes

In 1995, apparently in response to losses on its portfolio of rental housing insured mortgages, CMHC initiated substantial changes in its practices with respect to mortgage insurance for rental housing. The most highly-publicized aspect of the changes involved a substantial increase in the fees for mortgage insurance – for example, the mortgage insurance fee for 85% LTV mortgages rose from 2.5% (3% with construction draws) to 5% (5.5% with draws).

In addition to introducing higher mortgage insurance fees, CMHC substantially tightened the underwriting criteria applied to determine the lending value for rental projects – criteria which were designed to limit the potential size of the mortgage. Key components of these tightened criteria were:

- Minimum 9% cap rates for new rental projects regardless of the actual market cap rates in the market area where the project is located. While 9% may have been indicative of a typical market cap rate in 1995, in recent years, market cap rates in many major centres have fallen well below 9%.
- Minimum debt coverage ratios (DCRs) of 1.1 based, not on the actual loan payments, but instead on the payments which would apply on the loan assuming it had a 9% mortgage interest rate and a 35-year amortization period. This requirement was imposed in order to protect CMHC in the event that the project mortgage had to be re-negotiated at a higher interest rate (e.g. 9%) upon mortgage renewal. Subsequently, market mortgage interest rates dropped well below 9% – the likelihood of projects having to renew their mortgages at 9% became increasingly remote in recent years.

When they were introduced in 1995, these underwriting criteria did not appear as restrictive as they do today – as noted, market cap rates in many larger Ontario cities (as well as mortgage interest rates) are currently much lower than those reflected in these CMHC underwriting criteria (which, as discussed later in this section, were the 'official' CMHC underwriting criteria for new rental housing until March 2002). The result was that, in recent years, strict application of the criteria to a new rental project resulted in a significant reduction in the size of the potential mortgage.

The effects of these restrictive underwriting criteria on the economics of the illustrative rental project are illustrated in Exhibit 3-1.

Exhibit 3-1:

**Varying Cap Rates and Loan to Value Ratios
Illustrative Rental Project, Toronto**

(\$ per unit)

	85% Loan to Value Ratio			80% Loan to Value Ratio		
	9% Cap Rate	8.5% Cap Rate	8% Cap Rate	9% Cap Rate	8.5% Cap Rate	8% Cap Rate
Development Costs and Financing						
Project Costs	147,763	147,763	147,763	147,763	147,763	147,763
Equity	30,652	23,763	22,164	37,541	31,057	29,553
Mortgage (excluding fee)	117,111	124,000	125,599	110,222	116,706	118,210
Mortgage Insurance Fee*	5,856	6,200	6,280	2,756	2,918	2,955
Total Mortgage	122,967	130,200	131,878	112,978	119,624	121,166
Lending Value						
(based on NOI/Cap Rate)	137,778	145,882	155,000	137,778	145,882	155,000
Maximum Loan	117,111	124,000	131,750	110,222	116,706	124,000
First Year NOI and Cash Flow						
NOI	12,400	12,400	12,400	12,400	12,400	12,400
Mortgage Payments	9,884	10,465	10,600	9,081	9,615	9,739
(excluding MIF)	9,413	9,967	10,095	8,860	9,381	9,502
Cash Flow	2,516	1,935	1,800	3,319	2,785	2,661
Cash-on-Cash Return						
	8.2%	8.1%	8.1%	8.8%	9.0%	9.0%
DCR (based on mortgage payment excluding MIF)						
At 6.5%	1.32	1.24	1.23	1.40	1.32	1.31
At 9% (35 years)	1.14	1.08	1.07	1.21	1.15	1.13

* Mortgage insurance premiums introduced in 1995: 5% for 85% LTV mortgages; 2.5% for 80% LTV mortgages

Key elements of the exhibit include:

- An investor seeking an 85% LTV loan would face a lower level of mortgage financing if the lending value was based on a 9% cap rate (\$117,111) than if an 8.5% cap rate applied (the base case here: \$124,000). With an 8% cap rate (typical for a new project in Toronto today), the value of the project [\$155,000 (\$12,400/0.08)] actually exceeds the estimated development cost; since CMHC will underwrite mortgage insurance on the *lesser* of lending value and actual cost, the 85% mortgage would be \$125,599 (85% of \$147,763).
- At the time these underwriting criteria were introduced, few markets had cap rates below 9%. However, in subsequent years, cap rates dropped in many major markets. CMHC's requirement for a minimum 9% cap rate therefore had the effect of reducing the loan amount (increasing the equity from the investor), compared to the higher loan amount (and lower equity) which would have been possible if market-based cap rates were used.
- The 5% mortgage insurance fee introduced in 1995 doubled the cost of obtaining high-ratio financing. The dramatic difference, compared to the fee for 80% LTV loans, was

evidence that CMHC was seeking to discourage higher ratio 85% LTV loans, and shift business to the 80% (or lower) LTV level, where risk and claims tend to be lower. The 1995 mortgage insurance fees are used in this Exhibit, rather than the fees introduced in March 2002 (which are used in the base case in Exhibit 2-1).

- The minimum 1.1 DCR requirement (calculated at 9% over 35 years) was a further restriction on the size of the mortgage. The \$117,111 mortgage at the 9% cap rate (85% LTV) would qualify under the requirement; however, 85% mortgages at lower cap rates (had this been allowed) would not have met the minimum DCR requirement.
- If investors sought to avoid the (much higher 5%) mortgage insurance fee by taking out an 80% LTV mortgage, the use of a 9% cap rate also restricted the potential size of the mortgage (80% of lending value using a 9% cap rate is \$110,222, compared to \$118,210 if an 8% cap rate is used). For 80% LTV loans, the minimum DCR requirement did not restrict the allowable mortgage. Also, because of the much smaller mortgage insurance fee, the cash-on-cash return is greater than at the higher 85% LTV.

During the second half of the 1990s, in strong rental markets, such as Toronto, cap rates dropped to less than 9%. In these markets, CMHC's underwriting practices effectively restricted the size of the mortgages available for rental projects to well below what they would have been if market cap rates were used. The fee increases also discouraged investors from applying for 85% LTV loans – thereby increasing the amount of equity required for a rental project.

1998 Changes

When they were first introduced, the underwriting criteria discussed above applied to both *new* and *existing* rental projects. In 1998, CMHC introduced changes to the underwriting criteria and revised mortgage insurance fees for *existing* rental projects. The underwriting criteria utilized *market* cap rates and revised DCR requirements. The DCR calculation accepted the actual mortgage interest rate but, in addition, revised the calculation of DCRs to require a minimum DCR of 1.3 for mortgages with terms of less than 10 years, and 1.2 for mortgages with terms of 10 or more years. As noted, the previous criteria used a DCR of 1.1 (but at the 9% mortgage rate and a 35 year amortization) – the significance of these changes in CMHC's DCR requirements is discussed later.

The changes in CMHC's underwriting criteria for *existing* rental projects, and particularly the use of actual market cap rate, were effective in improving the attractiveness of CMHC mortgage insurance for investors in existing rental projects. As discussed in the federal tax report, many investors (especially institutional investors such as pension funds and REITs) prefer *existing* rental projects because they are less risky – there is less uncertainty about revenue/cost projections on an existing rental project compared to a new project – and, unlike new construction, value (based on market cap rates) tends to be closer to actual cost (purchase price). For investors in existing rental projects, the use of a market cap rate led to higher lending values – this increased the possible loan amounts at mid range LTV ratios of 60%-75% (where fees were lower), and enhanced returns to investors by both increasing leverage and achieving the lower interest rates achievable with CMHC insurance.

At the time these changes in underwriting criteria were introduced for *existing* rental projects, CMHC staff indicated that, while the official CMHC underwriting criteria with respect to *new* rental projects had not been changed, the Corporation was examining further potential changes and would be 'flexible' in applying these (obviously outdated) criteria for *new* rental projects – i.e. they might be prepared to overlook the 'official' minimum 9% cap rate requirement and use a cap rate which more closely reflected market realities.

2002 Changes

Following the 1998 changes in CMHC's underwriting criteria for *existing* rental projects, there were increasing calls for a review of the Corporation's mortgage insurance practices with respect to *new* rental housing projects – including the (May 2001) recommendation from the Province of Ontario's Housing Supply Working Group cited in the Introduction to this report. On December 12, 2001, CMHC announced changes in both the fees and the official underwriting criteria for CMHC-insured mortgages for new rental projects which had been in place since 1995.⁵

Exhibit 3-2:
CMHC Mortgage Insurance Fees
for Rental Housing Projects
 (% of Loan)

LTV	Existing Rental	New Rental (6+ Units)			
		Loan Advanced on Completion		Construction Advances	
		Previous	2002	Previous	2002
-65%	1.75	2.00	1.75	2.50	2.25
66-70%	2.00	2.00	2.00	2.50	2.50
71-75%	2.25	2.00	2.25	2.50	2.75
76-80%	3.50	2.50	3.50	3.00	4.00
81-85%	4.50	5.00	4.50	5.50	5.00

Exhibit 3-2 summarizes the previous and current (March 2002) CMHC mortgage insurance fees for new and existing rental projects:

- The 2002 changes effectively equate the mortgage insurance fees for existing rental projects and new rental projects – providing that no construction advances are required for the new projects.
- The fees range upward from a low of 1.75% for rental projects with LTVs of 65% or less to 4.5% for projects with LTVs of more than 80%. New projects with construction advances incur an additional fee of 0.5% compared to those with only take-out financing at the completion of the project – this surcharge is unchanged from the previous criteria.

⁵ Much of the information in this section is taken from a CMHC document, *Rental Mortgage Insurance Product Enhancements Effective March 1, 2002*, December 12, 2001.

- Compared to the previous fees, there is a reduction of 0.5% for rental projects with LTVs above 80%; however, projects with LTVs of 71%-80% face somewhat higher fees than previously (an increase of 1% for 76%-80% LTV projects).
- The new fee schedule rectifies an anomaly created when CMHC adjusted the mortgage insurance fees (and underwriting practices, as discussed above) for *existing* rental projects in 1998 – but did not change the fees for *new* projects. Previously, in some LTV ranges (e.g. 71%-75% and 76%-80%), the mortgage insurance fees for (one advance) new projects were actually less than for existing projects – as noted, these fees will now be the same.

In addition to the revised premium schedule, CMHC announced changes in their underwriting criteria related to cap rates and DCRs. According to the CMHC release:

“CMHC will now use market derived capitalization rates to determine the lending value, the loan to value ratio and the amount of premiums payable. The use of the 9.0% minimum capitalization rate will be discontinued.

“... Rather than basing the debt coverage ratio (DCR) for underwriting purposes on a minimum 9% [mortgage interest] rate, CMHC will now use the borrower’s actual interest rate in calculating the DCR. The use of the minimum 9% as an interest rate to calculate the DCR is discontinued.”⁶

Effect of New Minimum DCR Requirements

The positive effect of using market cap rates (rather than a minimum 9% cap rate) on the potential value of the mortgage loan for a new rental project has already been discussed – see Exhibit 3-1. However, the analysis here illustrates that the effect of this change (the use of *market* cap rates) is offset to some extent by the new minimum DCR requirements.

CMHC’s previous and current DCR requirements for new rental projects are as follows:

- Prior to March 2002, the minimum DCR was 1.1, based on a 9% mortgage interest rate amortized over 35 years.
- CMHC now uses the *actual* mortgage interest rate, but has raised the minimum DCR to 1.3 for mortgages with terms of less than 10 years, and 1.2 for mortgages with terms of 10 or more years. The same DCR requirements apply to existing rental projects.

Exhibit 3-3 demonstrates the effects of the change in the minimum DCR requirements using the illustrative project discussed earlier. The top part of the exhibit presents the DCRs which would result at various mortgage interest rates for the maximum (85% LTV) loan (\$124,000) which would be available to a project with NOI of \$12,400 annually, based on an 8.5% cap rate (disregarding DCR requirements). This is the base case used in this report (e.g. Exhibit 2-1) and other reports in this series.

⁶ CMHC, December 12, 2001, page 1.

The DCRs are presented for various interest rates (assuming a 25 year amortization period). The \$124,000 maximum financing (based on the cap rate approach) results in DCRs ranging from 1.37 for a 5.5% interest rate (NOI of \$12,400 divided by the mortgage payment of \$9,083), to 1.09 for an 8% mortgage interest rate.

For comparison purposes, the DCR for a 9% mortgage amortized over 35 years (the basis for the previous CMHC DCR requirement) would be 1.08. This is less than the previous CMHC minimum DCR requirement of 1.1 – i.e. CMHC would not have insured this large a loan.

Exhibit 3-3:

**Effect of New Minimum DCR Limits on Maximum Loan Amount
Illustrative Rental Project, Toronto**

	Mortgage Rate/Amortization Period						Previous Policy
	5.5%/25	6.0%/25	6.5%/25	7.0%/25	7.5%/25	8.0%/25	
Loan \$124,000 (excluding 4.5% CMHC Fee):							
NOI	12,400	12,400	12,400	12,400	12,400	12,400	12,400
Mortgage Payment	9,083	9,520	9,967	10,422	10,886	11,357	11,483
Actual DCR	1.37	1.30	1.24	1.19	1.14	1.09	1.08
Maximum Loan Based on DCR Limit:							
10+ Year Term							
Minimum DCR	1.2	1.2	1.2	1.2	1.2	1.2	1.1
Maximum Loan	141,075	134,589	128,558	122,943	117,710	112,827	121,724
Up to 10 Year Term							
Minimum DCR	1.3	1.3	1.3	1.3	1.3	1.3	1.1
Maximum Loan	130,223	124,236	118,669	113,486	108,655	104,148	121,724

The bottom half of Exhibit 3-3 presents the actual maximum financing that would be available for the illustrative project based on CMHC's 2002 DCR requirements. Key points include:

- To obtain the maximum loan available (\$124,000 – based on the lending value approach), the project would need to be financed with a mortgage interest rate of:
 - Less than 7% (with a 10-year term or longer);
 - 6% or less (for terms less than 10 years).
- At higher interest rates (e.g. 7% and above for a 10-year term loan), a loan of \$124,000 would breach CMHC's requirement for a minimum 1.2 DCR for 10+ year term mortgages. Similarly, at more than 6% (less than 10-year terms) the \$124,000 loan would breach the requirement for a minimum 1.3 DCR for a mortgage with less than a 10-year term.
- Mortgages with lower interest rates than 7% (10+ year term) or 6% (less than 10-year term) would be eligible for a higher loan (based on the DCR requirement). However, in these cases, the value of the loan would be constrained by the maximum \$124,000 loan – which is 85% of the lending value, based on an 8.5% cap rate.

- CMHC's pre-March 2002 minimum DCR requirement of 1.1 (for a 9% mortgage amortized over 35 years) would restrict the mortgage to a maximum of \$121,724. Thus, at mortgage rates of 7% or less (10-year term), CMHC's new DCR requirements will result in a higher loan amount. At 10-year rates above 7%, the eligible financing will be less than with the previous DCR requirements.

Thus, with the new DCR requirements, the maximum loan available is highly sensitive to the mortgage interest rate. Requiring some minimum DCR is, of course, prudent underwriting. Without such a restriction, for example, the project might be eligible for the maximum \$124,000 loan even if the mortgage interest rate was as high as 8% – i.e. NOI was only 9% higher than the mortgage payments. Prudent underwriting likely requires a greater cushion than that.

The specifics behind the reasons for the choice of a 1.2 DCR for 10+ year term mortgages and a 1.3 DCR for mortgages with shorter terms were not provided by CMHC.

Current Mortgage Interest Rates

At present, interest rates are at the low end of the cycle. Typically, CMHC-insured mortgages are priced 65-85 basis points above the comparable term Canada bond – depending on market conditions and the term of the mortgage. Recently, 10-year term Canada bonds have yielded in the 5.2%-5.7% range, while 5-year bonds have been in the 4.3%-5.1% range – at the time of writing this report, both were at the top end of these ranges. At these bond yields, the interest rates on CMHC-insured mortgages would have been roughly:

- 6%-6.5% (10-year term)
- 5%-5.8% (5-year term).

At these mortgage interest rates, the 2002 CMHC DCR requirements do not represent a serious constraint on the size of the loan. As illustrated in Exhibit 3-3, at less than 7% (10+ year term), and 6% or less (less than 10-year term), the maximum mortgages available (based on the DCR requirement) would exceed the \$124,000 established by the 85% LTV (using an 8.5% cap rate).⁷

However, for new rental projects, there is a serious risk that rates may be significantly higher than at present when the projects are completed – typically 18-24 months from the start of construction for a large project. For example, according to the *CMHC Housing Outlook* (Fourth Quarter 2001), 5-year mortgage interest rates will be in the 6.5%-7.5% range by the end of 2002 – even allowing for discounting, this would likely be 0.5%-1.5% above recent 5-year rates. For 10-year term mortgages, (discounted) rates could be in the 7%-8% range. At these interest rates, the DCR requirements would limit the size of the loan (particularly, as is discussed in the next section, for projects with market cap rates of 8% or less).

To provide assurance regarding rates for new projects when they are completed 12-24 months following the start of construction, developers can 'lock-in' a rate into the future. According to discussions with financial industry stakeholders, given the expectation that interest rates will rise

⁷ As discussed in the next section, at a lower cap rate (e.g. 8% as is typical in strong rental markets such as Toronto and Ottawa), the interest rate at which the DCR becomes the constraint is lower than in the example presented here (which is based on an 8.5% cap rate).

over the next few years (due to an expected economic recovery), the cost of locking-in a rate is currently very high:

- For one year hence, locking in a rate for a 10-year term mortgage costs roughly 50 basis points above current rates (i.e. 6.5%-7%);
- For two years hence (the probable completion date for a new project planned today), the cost of locking in a 10-year term mortgage is roughly 100 basis points (i.e. 7%-7.5%).

As illustrated in Exhibit 3-3, at interest rates of more than 7% (10+ year term), the 2002 DCR requirement would result in a maximum loan which is less than the \$121,724 allowed under previous CMHC DCR criteria. Also, at interest rates of 7% or more, the DCR requirement would restrict the mortgage to less than an 85% LTV mortgage using an 8.5% cap rate.

Maximum Loans Under Various Interest Rate/ Cap Rate Scenarios

Exhibit 3-4 presents a summary of the maximum financing which CMHC will insure (with the 2002 underwriting criteria) for the illustrative rental project under various combinations of cap rates, interest rates and loan terms. It shows the sensitivity of the financing available to investors if interest rates vary and/or there are disputes about the appropriate cap rate to use for a project.

Exhibit 3-4:

Maximum Loan on Rental Project with \$12,400 Net Operating Income Illustrative Rental Project, Toronto

	Cap Rate (as basis of lending value)					
	10.0%	9.5%	9.0%	8.5%	8.0%	7.5%
Max Loan 85% LTV	105,400	110,947	117,111	124,000	131,750	140,533
Loan term 10+ years (Minimum DCR 1.2)						
Interest Rate	Maximum Loan (lesser of 85% LTV or 1.2 DCR at various mortgage interest rates)					
5.5%	105,400	110,947	117,111	124,000	131,750	140,533
6.0%	105,400	110,947	117,111	124,000	131,750	134,589
6.5%	105,400	110,947	117,111	124,000	128,558	128,558
7.0%	105,400	110,947	117,111	122,943	122,943	122,943
7.5%	105,400	110,947	117,111	117,710	117,710	117,710
8.0%	105,400	110,947	112,827	112,827	112,827	112,827
Loan term < 10 years (Minimum DCR 1.3)						
Interest Rate	Maximum Loan (lesser of 85% LTV or 1.3 DCR at various mortgage interest rates)					
5.5%	105,400	110,947	117,111	124,000	130,223	130,223
6.0%	105,400	110,947	117,111	124,000	124,236	124,236
6.5%	105,400	110,947	117,111	118,669	118,669	118,669
7.0%	105,400	110,947	113,486	113,486	113,486	113,486
7.5%	105,400	108,655	108,655	108,655	108,655	108,655
8.0%	104,148	104,148	104,148	104,148	104,148	104,148

Key elements of the exhibit include:

- The first row presents the financing that would be available (assuming an 85% LTV loan and NOI of \$12,400 annually) at various cap rates (and no DCR limits). For example at

an 8.5% cap rate, the maximum loan would be \$124,000 (the base case – as illustrated in Exhibit 3-3). With a lower cap rate (e.g. 8%), the lending value would be higher⁸, and an 85% LTV loan would be \$131,750. According to many observers, 8% would be a realistic cap rate for a new rental project in Toronto or Ottawa.

- The remainder of the table shows the maximum loan which CMHC would insure, based on various combinations of cap rates and interest rates and terms – and including consideration of CMHC's 2002 DCR limits. For example:
 - With a term of 10+ years, the minimum DCR is 1.2. Assuming a 6.5% interest rate, the 1.2 DCR yields a maximum loan of \$128,558 (see Exhibit 3-3) – this is greater than 85% of lending value for cap rates above 8%, so the maximum mortgage CMHC will insure will be based on the (cap rate-determined) lending value at cap rates above 8%. For cap rates of 8% or less, the DCR limit will dictate the size of the mortgage.
 - With a term of less than 10 years, the minimum DCR is 1.3. Assuming a 5.5% interest rate, the 1.3 DCR yields a maximum loan of \$130,223 (see Exhibit 3-3) – this is also greater than 85% of lending value for cap rates above 8%. For cap rates of 8% or less, the DCR limit will dictate the size of the mortgage.
- The shaded portion of Exhibit 3-4 presents the combination of interest rates and cap rates where CMHC's 2002 DCR requirements will be the primary constraint.
- The boxed area on Exhibit 3-4 reflects the current cap rates in major Ontario centres – as well as the interest rates which would apply to new rental projects (including the current rates and rates which might be obtained if investors lock-in rates into the future).
- The exhibit illustrates the effect which CMHC's 2002 DCR requirements will have if interest rates rise from current levels. Assuming the project has a cap rate of 8% and, therefore, a maximum loan (based on 85% LTV) of \$131,750:
 - At current interest rates (5%-5.8% 5-year term, and 6%-6.5% 10-year term), the DCR requirements are right on the borderline in terms of restricting the mortgage amount.
 - If interest rates rise from current levels, and/or if developers attempt to lock-in interest rates (by paying a premium in interest), the DCR requirements will restrict the size of the mortgage below what would be available at today's interest rates.

The key conclusion from Exhibit 3-4 is if there is a rise in interest rates, or if developers pay a premium to lock-in rates, the 2002 DCR requirements will limit the size of the mortgage.

Under the previous CMHC underwriting criteria, the loan amount would have been constrained either by the minimum 9% cap rate (loan amount of \$117,111) or the 1.1 DCR requirement (at a 9% mortgage over 35 years (\$121,724). A project in Toronto with an 8% cap rate could, at current interest rates and with CMHC's 2002 DCR requirements, get a larger mortgage. However, if interest rates rise to (say) 7.5% (10-year term), or the developer locks-in at that rate,

⁸ Unless project development cost was less than the lending value, which is assumed not to be the case in this example which seeks only to illustrate the trade-offs between DCR requirements and cap rates at various interest rates.

the maximum mortgage will be \$117,710 – about the same as with the 9% cap rate under the previous CMHC criteria. To the extent that, as discussed, CMHC was ‘flexible’ in applying the 9% cap rate, the new DCR requirements could result in a lower loan amount than was possible previously.

Cap Rate/DCR Work in Tandem

From the above, it is apparent that cap rates and the DCR limits work in tandem. As the cap rate and interest rate situation changes, the primary constraint also shifts. Exhibit 3-5 summarizes the results of the analysis underlying Exhibit 3-4 to illustrate which of the CMHC underwriting criteria dictate the size of the loan at various combinations of interest rates and cap rates.

Exhibit 3-5:

Primary Loan Constraint at Various Cap Rates and Interest Rates Illustrative Rental Project, Toronto

		Cap Rate (as basis of lending value)					
		10.0%	9.5%	9.0%	8.5%	8.0%	7.5%
Loan term 10+ years (Minimum DCR 1.2)							
<i>Interest Rate</i>							
5.5%	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value
6.0%	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value	DCR
6.5%	Lend Value	Lend Value	Lend Value	Lend Value	Lend Value	DCR	DCR
7.0%	Lend Value	Lend Value	Lend Value	Lend Value	DCR	DCR	DCR
7.5%	Lend Value	Lend Value	Lend Value	DCR	DCR	DCR	DCR
8.0%	Lend Value	Lend Value	DCR	DCR	DCR	DCR	DCR
Loan term < 10 years (Minimum DCR 1.3)							
<i>Interest Rate</i>							
5.5%	Lend Value	Lend Value	Lend Value	Lend Value	DCR	DCR	DCR
6.0%	Lend Value	Lend Value	Lend Value	Lend Value	DCR	DCR	DCR
6.5%	Lend Value	Lend Value	Lend Value	DCR	DCR	DCR	DCR
7.0%	Lend Value	Lend Value	DCR	DCR	DCR	DCR	DCR
7.5%	Lend Value	DCR	DCR	DCR	DCR	DCR	DCR
8.0%	DCR	DCR	DCR	DCR	DCR	DCR	DCR

Highlights of Exhibit 3-5 include:

- At higher cap rates the main constraint is the lending value – particularly for loans with terms of more than ten years.
- With the 1.3 DCR requirement for loans with terms below 10 years, the DCR constraint is much more significant. When market cap rates are below 9%, the DCR is almost always the key constraint on the maximum loan. Lending value is triggered only when interest rates are below 6%.
- With the lower 1.2 DCR minimum applied to longer-term mortgages (10 years or more), the lending value is a more important constraint. Nonetheless, if cap rates are less than 9%, lending value is the constraint only in a very low interest rate environment – such as that which prevails today. At interest rates of 6.5% or more (which is likely for 10-year

financing over the coming year, particularly for locked-in rates) the DCR is the key limit on the loan amount.

- In general, at higher interest rates, the DCR limits become the constraining factor for the maximum loan. At higher cap rates, the lending value becomes the constraining factor.

Conclusion – the Effect of the 2002 DCR Requirements

As discussed above, at current interest rates, the changes in CMHC's underwriting criteria appear to result in higher maximum loan values than with the previous underwriting criteria (i.e. 9% cap, 9% interest rate 35 years). If interest rates fall further, the potential maximum loan could be higher still.

However, if rates rise from current levels, as is the general expectation (including CMHC's Market Analysis Centre), the effect of the changes could be relatively small – or negative. At interest rates above current levels, and especially for developers seeking to lock-in a rate for an extended period, the new underwriting criteria will be more constraining than those previously in effect. A *reduction* in the amount of mortgage financing available would, of course, have very serious implications for the viability of new rental production.

Other CMHC Requirements

The arrangements surrounding insurance for mortgages on rental properties involve more than just mortgage insurance premiums, cap rates and DCRs – the factors discussed above. There are also a number of other requirements and procedures associated with obtaining CMHC mortgage insurance on rental properties – including:⁹

- **Rental achievement** – loan advances are limited to up to 75% of the costs or lending value (whichever is less). The remainder of the loan will be advanced once the project has achieved a stable income at the projected rent levels sustained through one full operating year.

In one sense, this is more favourable (to developers) than the previous guidelines, which restricted advances to 75% of the *loan amount* (not lending value) pending completion and rental achievement. However, previously, developers would not have to wait a full year after rental achievement to receive the full loan amount. This latter requirement will mean that developers with high-ratio loans will have to retain bridge financing for a longer period than previously; it will also significantly complicate negotiations with the ultimate lender since the full value of a high-ratio loan will not be advanced until more than a year following completion of a rental project.

- **Additional guarantees** – during construction, CMHC requires a guarantee of 100% of the loan amount. Following completion, once the project has achieved a stable income at the projected rent levels, the guarantee requirement is relaxed – required guarantees are

⁹ The details on the 2002 CMHC requirements are from the December 12, 2001 CMHC release. Previous CMHC requirements are from the CMHC publication, *Standing the Test of Time: Rental Mortgage Loan Insurance*, 1999.

equivalent to 2% for every 1% increment in the LTV ratio above 60%. For 85% LTV loans, therefore, the guarantee would be equivalent to 50% of the loan amount [$2 \times (85 - 60) = 50$]. These guarantees are in addition to the project equity held by the investor. Similar provisions regarding guarantees previously applied for existing rental projects (revised in 1998); however, for new projects there were previously no restrictions on the guarantees.

CMHC also requires that the borrower have a net worth equal to at least 25% of the loan amount, with a minimum of \$100,000 – this is unchanged from the previous requirement. As the DCR increases, CMHC is willing to allow for some flexibility in the minimum net worth.

- **Surcharges on mortgage insurance premiums** – there are a variety of surcharges on the premiums (in general, these are similar to the surcharges that previously applied):
 - For loans with construction advances, there is a surcharge of 0.5% – this is the same as previously.
 - For loans with amortization periods longer than 25 years, there are surcharges of 0.25% (30 years) and 0.5% (35 years)¹⁰ – these surcharges previously did not apply to new projects; however, they were part of the changes introduced by CMHC for existing rental projects in 1998.
 - For loans involving some non-residential space, there is a surcharge of 1.0% of the portion of the loan related to such space – this is the same as previously.
- **Underwriting fees** – CMHC charges underwriting fees of \$150 per unit (for the first 100 units) and \$100 per unit (for additional units); the minimum fee is \$600 (the amount for a project with 4 units) and the maximum is \$50,000 (the amount for a project with 450 units). These are the same as those for existing rental projects (adjusted in 1998) – for new rental projects, the previous fees were somewhat lower: \$150 per unit for the first 50 units, and \$75 on the remaining units.

Many of these additional requirements, such as rental achievement and guarantees, are designed to limit CMHC's risk exposure. Not advancing the full amount of a high-ratio loan until the project is fully rented at the projected rents will limit CMHC's potential losses in the event that the market rent forecasts are too optimistic. Guarantees allow CMHC to pursue the investors and recoup losses, in the event of loan defaults.

Limiting risk exposure appears prudent, however, some stakeholders point out (see next section) that this needs to be balanced by the other requirements imposed by CMHC. Many stakeholders believe that, given the guarantees, for example, there might be an argument for lower mortgage insurance fees and/or less restrictive underwriting criteria (e.g. DCRs).

¹⁰ This surcharge impacts on developers that seek to reduce mortgage payments by using a longer amortization period. For non-profit corporations, for example, the use of a longer amortization period permits a modest reduction in breakeven rent levels.

4. **Stakeholder Comments on CMHC Mortgage Insurance Practices**

A key goal of this report is to identify the types of changes in CMHC's mortgage insurance practices and procedures which could enhance the economics of investment in new rental housing. To assist in this process, a series of interviews were undertaken with stakeholders (mainly real estate companies and financial experts) who had experience in dealing with CMHC – several of the interviews (and follow-ups on earlier interviews) were undertaken following the December 2001 announcement of the changes in CMHC's mortgage insurance underwriting criteria.

The comments from stakeholders are presented here – they are the views of the stakeholders, and do not necessarily reflect the views of the authors of this report. Stakeholder comments include:

- **Importance of mortgage insurance** – most stakeholders emphasized the importance of mortgage insurance in financing new rental projects. There is a clear sense among most stakeholders that CMHC has an extremely important role to play in promoting investment in new rental construction. There is also a clear sense of disappointment that (as discussed below) CMHC's past policies and premiums were not perceived to be supportive of this goal.
- **CMHC mandate** – stakeholders generally understand CMHC's mandate to operate their mortgage insurance functions on a 'commercial basis'. However, they also point to the broader federal government goal of promoting the construction of rental housing and believe that CMHC should be seeking to 'push the envelope' by being more flexible in terms of mortgage insurance for rental housing. Some noted CMHC's profits on its overall mortgage insurance operation and wondered whether this might indicate that the Corporation is excessively conservative in its underwriting. Several question why CMHC's mortgage insurance functions should be retained in a crown corporation if the Corporation is unwilling to promote the broader public policy goal of facilitating rental investment by taking on more risk.
- **Mortgage insurance fees** – not surprisingly, many stakeholders believe the mortgage insurance fees for rental projects are too high (even with the 2002 changes). Of course, no one has access to CMHC's actuarial analyses so suspicions in this regard cannot be based on actual assessments of the risks involved to CMHC; however, there is a widespread view that even the new fees are too high. While most stakeholders appear to accept that CMHC's pre-1995 fees may have been too low in view of the losses in CMHC's rental portfolio, several pointed out that some of these losses were on nursing home projects (which is a totally different type of business). Also, the rental projects that defaulted prior to the 1995 changes would have been approved using vastly different underwriting criteria than are in place today – including mortgages on questionable tax shelter developments. Many question whether the *combination* of high fees and strict underwriting criteria (plus substantial requirements for personal guarantees) is justified.

Stakeholders also observed that, since CMHC has a monopoly on a highly attractive financing mechanism (government-guaranteed loans), they face little commercial pressure to reduce their fees. In the final analysis, as long as CMHC insurance results in a more attractive return than conventional financing, investors will have little option but to pay the fees. On the other hand, some observers noted that there is another mortgage insurance company in Canada (GEMICO) and, since they do not appear interested in offering insurance on rental housing loans, then CMHC's fee schedule must not be *too* out of line, in view of the risks involved.

- **The application and approvals process** – stakeholders have found the process involved in obtaining CMHC mortgage insurance to be (in their view) excessively lengthy, opaque and frustrating – especially in recent years. Complaints included disputes regarding the appropriate cap rates, disagreement about projected market rents (despite access to independent market analysis and rental achievement holdbacks) and conservative assessments of potential property taxes payable. Several indicated that, after what were perceived to be fruitless discussions with CMHC, they either opted for conventional financing for similar loan amounts (but more market-oriented lending values) or decided to build condominiums instead.

Many stakeholders believe that CMHC is excessively conservative in its market analysis of rental projects. An example is the practice (with existing rental projects) of taking the current rent roll as the basis for determining revenues: with rent decontrol in Ontario, units with (controlled) below-market rents are moving to (much higher) market rents when tenants vacate – failure to recognize the below-market nature of current rent rolls results in a much lower lending value (and higher mortgage insurance fee for a given loan amount) than if more realistic market rent levels were used. A rental achievement hold-back (as is used in new construction) could be the mechanism to protect CMHC in such cases. At present, if an owner accepts the lower loan and subsequently, once rents increase and higher revenues can be demonstrated, seeks refinancing, CMHC charges a new fee on the *full value* of the refinanced loan, rather than only the incremental increase (see below for stakeholder comments on 'double dipping').

- **Underwriting criteria** – the previous official underwriting criteria for new rental loans (9% cap rate, and DCRs based on a 9% mortgage interest rate) were clearly out of date. According to many stakeholders, while there was some evidence of 'flexibility' in the application of these criteria, the cap rates which CMHC applied to new projects were typically higher than market analyses would support (though sometimes less than the 'official' minimum 9% cap rate). Without access to all of the information, this is difficult for an independent observer to verify. Nonetheless, there is a general feeling among stakeholders that, by taking so long to replace their outdated official underwriting criteria (and by being excessively conservative, even when they were supposedly 'flexible'), CMHC did not appear to be particularly interested in insuring high-ratio mortgages for new rental housing projects.
- **'Market-derived' cap rate** – while CMHC indicates they will use a 'market derived' cap rate to determine the lending value of a rental project, there is considerable latitude in terms of selecting the appropriate cap rate to apply to a particular project. Moreover,

stakeholders point out that CMHC has a vested interest in utilizing a less favourable cap rate in the calculation of lending value since a lower lending value would place a given mortgage amount in a higher LTV range – with a higher mortgage insurance fee.

- **DCR requirements** – the analysis in Section 3 indicated that the new DCR requirements will likely limit the size of the mortgage loan which CMHC will insure (assuming interest rates rise above current levels). As discussed in the next section, the new DCR limits are similar to those used in the US; however, US lenders typically do not have the additional comfort of personal guarantees (a CMHC requirement). Also, CMHC's 2002 DCR limits for *new* rental projects are the same as those that apply to *existing* rental projects; one of the justifications for high DCRs on existing projects is the possibility that substantial renovation work may be required in future – this is unlikely to be a serious concern for new rental projects for some period. Many stakeholders would like to see a reduction in the DCR requirements for new rental projects.
- **Personal guarantees** – this is clearly (and understandably) a contentious point with borrowers. Many developers consider CMHC's requirements with respect to personal guarantees excessive. Some noted that personal guarantees are not common in the US – where loans for rental properties are typically non-recourse. Many stakeholders believe that personal guarantees should not be necessary if the underwriting for a loan is undertaken properly – or suggested that, perhaps, there should be some trade-off where, if personal guarantees are required, there may be some flexibility on the DCR requirements.

Some who chaffed at CMHC's personal guarantee policy were small developers who would have to tie up all of their equity to satisfy CMHC's requirements – and hence would not have the financial capacity to develop other projects. Others noted that rental development is a complicated, capital-intensive business and it is not entirely unwelcome to have some limits which ensure that developers have access to sufficient capital – though it is unclear whether personal guarantees are the best way to enforce this.

- **Encouraging experienced creditworthy developers** – stakeholders generally have sympathy with (and support for) CMHC's need to ensure that proposed rental projects are financially viable – and that developers have the experience and financial capability to build and operate the projects, even if market conditions weaken. However, several stakeholders believe that CMHC's underwriting criteria have been designed to fit the 'lowest common denominator' among developers – and are, as a result, driving many of the experienced creditworthy developers away from building new rental projects because the terms and conditions (not to mention the process) are too onerous.

In many respects, this may be due to a loss of experience in new rental development on the part of both CMHC and the development industry. In the past decade, there has been relatively little new rental development in Ontario – most multiple developers have been building condominiums and, before 1995, turn-key non-profit projects. Before 1990, most new rental projects (including many of the projects where CMHC experienced defaults) were tax shelters – a totally different approach to developing, financing and operating rental projects. Many stakeholders believe that the lack of experience with 'real' rental projects has led to excessive caution on the part of many in the industry –

both developers (who may not recognize the attractive long-term returns available from rental investment) and the financial community (including CMHC).

- **CMHC regulations** – some stakeholders cited examples of CMHC regulations which they believe do not make much sense. Examples include:
 - ‘Equity pulls’ – CMHC apparently has a list of ‘approved uses’ for which it is willing to underwrite the refinancing of a rental project to allow an investor access to some of the equity which has accumulated in the project. Most stakeholders question why CMHC should care about how such equity is to be used (as long as the mortgage is secure). CMHC’s requirements in this regard are irksome to investors and also require substantial administrative work on the part of lenders in ensuring the funds go to ‘approved uses’.
 - ‘Double-dipping’ on mortgage insurance fees – some stakeholders complained about CMHC’s practices on refinancing and when CMHC-insured buildings were sold to purchasers who want a higher volume of financing. In these cases, fees are collected on the total value of the higher mortgage amount, rather than the incremental financing required. According to these borrowers, CMHC should recognize the fee already paid on the existing financing and charge fees only on the additional financing required.
 - Mortgage insurance on ‘interest-only’ loans – some potential borrowers indicated that they believe CMHC should offer mortgage insurance on interest-only loans (i.e. loans which do not include principal repayments). Currently, CMHC offers insurance only on amortizing loans – and imposes additional surcharges on loans with longer amortization periods (0.5% more for a loan with a 35 year amortization). While interest-only loans would likely involve increased losses if a loan defaults (i.e. none of the principal would be repaid prior to the default), risks could be reduced by offering insurance only for projects with minimal risk – e.g. those with LTVs of 65% or less.
 - Variable rate mortgages – several stakeholders noted that CMHC has a firm policy of not insuring variable rate mortgages, even if there are upside limits on the rate. At present, lenders are willing to offer extremely attractive rates for mortgages (on a variable rate basis) with an option to borrowers to lock-in at a particular set (higher) rate in the future. Apparently CMHC is unwilling to insure such mortgages – even based on the higher lock-in rate. Thus, borrowers lose out on potentially attractive short-term rates.

Clearly, most stakeholders in the rental industry have strong views about CMHC’s mortgage insurance practices – this is indicative of the key role CMHC plays in the financing of new rental projects. Most stakeholders are critical of how the Corporation has operated its mortgage insurance business (especially in the recent past). It was apparent from the interviews that many stakeholders view CMHC as a ‘monopoly culture’ rather than a ‘customer-service culture’. While some hope that the recent changes in CMHC’s practices with respect to rental housing will be positive for the industry, many believe that they will not make a great deal of difference unless there is a change in attitude regarding rental housing loans – a willingness to abandon (what is seen to be) an excessively conservative approach and be more proactive in seeking solutions which will promote new rental construction.

While CMHC mortgage insurance is clearly a key component of rental mortgage financing in Canada, the following section briefly overviews the system for financing new rental housing development in the US – and the notable fact that, in the main, mortgage insurance is not a key part of the US landscape.

5. Financing Rental Housing in the US

This report is one of three being prepared for the HSWG. Another report (*The Context for Private Rental Housing Production in the US*) examines various aspects of rental production in the US, including financing issues. This section of the report highlights only the mortgage insurance and underwriting practices in the US, relative to those in Canada – readers seeking more detail on the US rental housing system should consult the companion report.

Mortgage Insurance in the US

In providing a widely available mortgage insurance program to assist the financing of rental development, Canada is fundamentally different from the US. In the US, although nine private mortgage insurance corporations actively offer insurance for homeownership mortgage loans, none of these companies currently provides insurance for multi-family rental projects.

In 1967, a private insurer, the Mortgage Guarantee Insurance Corporation initiated insurance on multi-residential rental properties to cover the top 20% of a loan in the event of default. This program was apparently quite successful until the real estate recession of 1974. Significant losses resulted in scaling back of coverage and re-pricing of fees. Vandell (2000) suggests that lack of understanding of the basic risk relationships in income property lending was the primary cause of these problems. This private insurance was discontinued in the mid 1970s.¹¹

However, as in Canada, a public agency, the Federal Housing Administration (FHA), does provide multi-family mortgage insurance. The FHA was created in 1934 and began insuring both homeownership loans and loans on income-producing properties at that time. Over the years, the FHA has operated a number of programs but, in the multi-family area at least, generally focused on a very specific part of the market where the private sector is inactive. The FHA role has consistently been to serve explicit public policy goals – to promote financing of properties for low-moderate income renters. Maximum mortgage levels cap loans to restrict FHA insurance to modest lower-cost properties. FHA premiums are directly subsidized and, each year, HUD must seek an appropriation to cover anticipated credit losses, due to the inadequacy of premiums in covering losses.

Today, FHA is still active but represents financing of only 6% of total multi-family starts.

¹¹ Kerry D Vandell. *Multifamily Finance: Pathway to Housing Goals, Bridge to Mortgage Market Efficiency* Journal of Housing Research, Vol. 11: 2 (2000).

Conventional Mortgage Financing

In lieu of insured loans, multi-family financing in the US has relied much more heavily on direct conventional lending by commercial banks and, beginning in the 1960s when large-scale high rise development emerged, through institutional investors. More recently, securitization (i.e. packaging mortgages into investments which are resold on the secondary mortgage market) and the development of the commercial mortgage-backed security (MBS) has provided both liquidity and established underwriting standards for investment properties. In addition, there has been a shift in the market with equity financing taking an increasing share – in the form of the Low Income Housing Tax Credit (see the companion US report) and, to a lesser extent, REITs (which tend to seek low LTV financing to leverage their equity position).

Prior to the mid 1980s, typical multi-family loans were 20-25 year fixed rate terms, but the interest rate spike of the early 1980s resulted in a dramatic shift in favour of 5-10 year term balloon mortgages with 30-year amortization (i.e. principal due and payable at term, but typically renewed, so these effectively emulate the Canadian roll-over mortgage). Reflecting higher default risk and perceived lower liquidity, mortgage interest rates were also typically well above those on conventional single family homes. In the 1990s, spreads narrowed, due to securitization as well as competition among lenders and a healthy appetite in the capital markets for securitized mortgage products. However, mortgage rates in the multi-family market remain higher than those for homeowner loans.

In the absence of CMHC-like widespread mortgage insurance, which has effectively established standardized underwriting across Canada, underwriting practices in the US are somewhat less standardized. In the main, underwriting standards are established by institutional investors and the two government sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac (see the companion US report for more detailed discussion of GSEs).

As a general practice, lenders will not lend beyond 80% of value (based on market cap rate and supporting appraisals), so developers in the US do not have access to the 85% LTV threshold made available by CMHC insurance in Canada. Life insurance companies prefer a maximum 75% LTV. Minimum DCRs in the US tend to be 1.25 to 1.30 (on mortgages which generally have amortization periods of 30 years). Typically, the loans are non-recourse – i.e. unlike the case with CMHC-insured loans, there are no personal covenants or guarantees for repayment of principal and interest on the mortgages.

Reflecting the fact that the risk is entirely carried by the original lender or secondary market purchasers, the mortgage rate reflects a risk premium – and, as a consequence, these spreads over government securities tend to be much wider than those in Canada for CMHC-insured loans. The spread charged on top of US Treasury bonds varies by mortgage funder:¹²

- Fannie Mae tends to have the most competitive rates (in part because their borrowing cost is lower due to the implicit government guarantee in their Charter), currently at 190 basis points on an 80% LTV (for a 60% LTV, the spread drops to 160 basis points).

¹² These spreads reflect a typical loan – however the mortgage market is highly competitive and in all cases reductions are provided to particularly creditworthy borrowers.

- Institutional investors (mainly life insurance companies) have a spread of 200-220 basis points, generally coupled with a 75% loan. The life insurance companies will also lock in their rate for an advance commitment of 60-90 days, unlike the GSEs and banks which will not lock the rate until closing.
- Capital market lenders – brokerage firms and commercial banks originating loans to create pools for commercial MBS are currently funding at 240-260 basis points over Treasuries, also with no forward commitment.

Clearly, the financing of rental development in the US takes place in a different environment than in Canada. In general, the lending criteria appear somewhat more onerous – spreads over the benchmarked government securities tend to be larger than in Canada, and the LTV tends to be lower (maximum of 80% rather than 85%) based on actual appraised market value.

Also, DCR limits in the US are comparable to the new 2002 CMHC DCR requirements (1.20-1.30).¹³ However, the loans are non-recourse (there is no personal covenant or guarantee) and are typically for longer (30-year) amortization periods – i.e. the mortgage payment (the denominator for the DCR) is less than would be the case with a 25-year amortization loan.

This brief comparison with the US sheds a different light on the issue of accessing financing for multi-family rental development. It suggests that mortgage insurance as a form of risk management and credit enhancement is not the only possible approach. It also suggests that, relative to the US, the terms and conditions upon which rental investors in Canada access financing with CMHC insurance may not be as unreasonable as some stakeholders might suggest: in Canada, with CMHC insurance, investors can obtain higher LTV loans at more favourable interest rates than are typical in the US. The DCR requirements are similar between Canada and the US. However, US loans are typically non-recourse – whereas CMHC requires guarantees for high-ratio loans.

6. Options for the Province to Facilitate Financing for New Rental Housing

The changes in CMHC's mortgage insurance fees and underwriting practices will help to address some of the concerns raised in the HSWG's initial report – concerns which were echoed in the consultations with stakeholders undertaken as part of the background for the preparation of this report. However, it is uncertain whether these changes will be translated into greater access to mortgage insurance for rental developers. Also, only time will tell whether some of the other concerns raised by CMHC's clients (e.g. perceptions of slow service, opaque decision-making processes, excessively conservative underwriting criteria, etc.) will continue to pose challenges for developers seeking rental mortgage insurance from CMHC. Finally, as discussed in Section

¹³ While the typical guideline is 80% LTV and 1.25 DCR, there are special programs that provide more favourable conditions. For example, Fannie Mae has a Targeted Affordable Housing product that permits 90% LTV and 1.1 DCR – however, this is linked to tax credit financed projects in which rents are set below market (and constrained) to achieve affordable guidelines, and the resulting lending value is suppressed. Based on true market rent, the LTV would be far lower than 90%.

3, the new underwriting criteria will not result in higher loan amounts for rental properties if interest rates rise.

If the Province considers that further action is necessary to facilitate mortgage financing for new rental housing, there appear to be four main options:

- Continue to press the federal government for more flexible financing terms for rental development;
- Partner with the federal government to provide improved service (by sharing risk);
- Form a Provincial mortgage insurance operation; or
- Explore private sector partnering alternatives to CMHC mortgage insurance.

These options are explored below. First, however, there are three key factors which need to be borne in mind with respect to the provision of mortgage insurance for rental housing:

- **The risks of mortgage insurance** – while rental markets are buoyant and rents are rising in many markets today, investments in new rental projects are inherently risky. Markets soften and rental projects sometimes fail – especially *new* rental projects which are launched on expectations of achievable rents and expected construction costs that are by no means guaranteed. It is instructive that GEMICO does not offer insurance for rental project loans, despite what many perceive as excessively-high fees being charged by its only competitor, CMHC. It is also notable that, in the US, where there are 9 large private corporations offering mortgage insurance on ownership housing, private mortgage insurance is not available for multi-family rental loans – only a government agency (the FHA) provides mortgage insurance, and then on subsidized terms to promote specific public policy objectives (i.e. rental housing targeted at low-income tenants). This suggests that there is not sufficient profitability in the rental mortgage loan insurance business to justify the initiation of private mortgage insurance. The Ontario government needs to be wary of entering a complex field where the potential losses are significant, unless prudent underwriting practices are employed.
- **The extensive underwriting infrastructure of CMHC** – while the development industry has difficulties with CMHC's mortgage underwriting and fee structure, it would be difficult (and costly) to replicate the expertise and analytical capability (as well as the financial backing of the Mortgage Insurance Fund) which are available to CMHC by establishing a provincially-run mortgage insurance organization. If the Province believes that CMHC is not performing appropriately, an alternative to forming a competitive Provincial agency is available. There would be obvious benefits to a partnership arrangement with the federal government (if satisfactory terms could be negotiated) which could utilize CMHC's underwriting infrastructure, rather than attempt to replicate this infrastructure through a new Provincial organization. There is a precedent for this approach in the federal/provincial loan insurance agreement used for social housing mortgages during the 1985-1994 period.
- **The federal government guarantee** – CMHC-insured mortgages enjoy the backing of the government of Canada – the most creditworthy agency in the country. In the case of catastrophic risk, where claims could exhaust the CMHC Mortgage Insurance Fund,

lenders are assured that the government of Canada would rectify any outstanding liability. While the government of Ontario also enjoys a strong credit rating, in financial markets, it is generally not considered as highly as the creditworthiness of the government of Canada. Mortgages backed by the Ontario government would likely not be considered as low a risk as those backed by the government of Canada – and, accordingly, the risk-adjusted mortgage interest rate to the borrower would not be as low.

These considerations are not intended to imply that there are no options available to the Province if CMHC's new mortgage insurance practices with respect to rental housing are considered to be wanting in terms of promoting access to mortgage financing for rental projects. They are presented here only as important background to the consideration of the options if it is considered necessary to act.

Press for More Flexible Financing Terms for New Rental Development

The changes in CMHC's underwriting requirements for new rental development are a step forward in today's interest rate environment. However, the analysis here has demonstrated that, if interest rates rise, the new DCR requirements will severely restrict mortgage amounts – particularly in strong rental markets (with low cap rates) such as Toronto and Ottawa.

Without access to the (confidential) detailed actuarial analyses undertaken by CMHC as background to the formulation of their underwriting practices and fees, it is not possible to assess whether the changes are consistent with prudent underwriting practices. Nonetheless, given that interest rates are likely to rise in future, there is a serious question whether the changes will provide the more flexible financing that the rental development industry is seeking. There appear to be three broad areas where the Province can press the federal government (and CMHC) to provide more flexible financing:

- **Analysis of risks of rental mortgages** – as noted, this is not possible without access to CMHC's actuarial analyses. However, as several of the stakeholders suggested, it might be appropriate to ask where the actual risks to CMHC are in its mortgage insurance underwriting practices. At present, CMHC employs a variety of risk mitigation measures to protect the Mortgage Insurance Fund from losses resulting from mortgage defaults on a rental project:
 - Mortgage insurance fees of up to 4.5% of the value of the mortgage to cover potential losses in case the project defaults;
 - Underwriting criteria (market cap rates and DCRs) to ensure that the loan is supported by the projected income stream from the project;
 - Rental achievement holdbacks to ensure that the full amount of the loan is not advanced unless the project has met its projected income stream (for a full year); and
 - Guarantees from the investors that, in the event of default, CMHC has recourse against other assets owned by the investor.

These are in addition to the minimum 15% equity that investors are required to commit to the rental project.

It seems legitimate to question why, for example, if personal or corporate guarantees are required from rental investors, it is also necessary to have strict DCR requirements which would limit the size of the loan to 1.2-1.3 times NOI. There would seem to be a case for some flexibility whereby if CMHC has adequate security (the project itself plus the investor guarantees), perhaps some of the other mitigation measures (e.g. DCR or mortgage insurance fees) might be relaxed to some extent. Alternatively, with these measures to contain default risk, is there room for greater flexibility on guarantee requirements?

- **CMHC's mandate** – again, as noted by the stakeholders, it seems legitimate to question why CMHC's mortgage insurance functions should be retained in a crown corporation if the Corporation is unable to promote the broader public policy goal of facilitating rental investment by taking on more risk. Given the evident profitability of CMHC's mortgage insurance operations, and the lack of new CMHC-insured rental housing loans, there would seem to be some room to manoeuvre by taking greater risks on rental mortgage insurance.¹⁴
- **The Bank Act** – at present federally chartered lenders are not allowed to make property loans in excess of 75% of property value without mortgage insurance. With no competition, this means that CMHC is the only option available for borrowers seeking high-ratio loans. In the US, lenders regularly provide financing equivalent to 80% of property value without mortgage insurance. It may be time to revisit this requirement and allow lenders to take on the additional risk associated with high-ratio loans without requiring mortgage insurance. This would create a separate source of risk assessment in which lenders will price risk in their interest rates, as is the practice in the US.

Thus, there appear to be several avenues available to the Province to encourage more flexible financing arrangements for rental housing.

Partner with the Federal Government to Share Risk on New Rental Development

Given the risks inherent in rental housing financing, the extensive underwriting infrastructure of CMHC, the benefits of geographic diversification to help manage regionally-based real estate cycles, and the low interest rates associated with the federal government guarantee on CMHC-insured loans, there would be advantages (to all stakeholders) from the establishment of a partnership between the Province and the federal government to provide enhanced access to mortgage insurance for rental housing. Alternative partnership approaches include:

¹⁴ As an alternative, if the federal government wishes to retain CMHC's commercial mandate, it might provide an explicit subsidy to CMHC to cover risk or claims relating to certain underwriting practices. For example, in the US, FHA insurance premiums are set below the level necessary to break even, so the government provides a claim subsidy. FHA also has a very specific public policy mandate to ensure financing is available, up to maximum loan limits, for modest affordable rental development.

- CMHC and the Province could develop a modified set of underwriting criteria to retain a sound basis for underwriting, but with lower fees and/or additional flexibility on maximum loan levels. CMHC could then offer mortgage insurance on these (more favourable) terms. This would require some risk-sharing arrangement whereby the Province might provide CMHC with a guarantee for part of the mortgage in the event of default in return for CMHC's agreement to underwrite a larger mortgage, and/or charge a lower (or no) mortgage insurance fee, or some other consideration.¹⁵
- The Province could reach an agreement with the federal government whereby the Province would indemnify CMHC against losses on additional loan amounts above what CMHC might normally insure on a rental project. Under this approach, CMHC would examine projects and identify the loan amounts and mortgage insurance fees which would apply, using their normal underwriting criteria. Then, at the option of an investor, the Province might examine the information from CMHC and, if additional financing was considered appropriate, the Province could enter into an arrangement with CMHC whereby the additional financing was added to the CMHC-approved loan – with the additional financing guaranteed by the Province. The Province could seek to indemnify its risk by charging some fee to the investor for this additional guarantee.

Such approaches would utilize CMHC's extensive underwriting expertise to provide an assessment of the appropriate financing for new rental projects, without requiring the Province to invest in creating such infrastructure. Such arrangements could also be restricted to projects that met specified goals – e.g. in terms of location, rents, clientele, etc.

A CMHC/Provincial partnership could be structured in a way that all of the rental projects with a Provincial guarantee could be grouped into a 'pool'; the Province would only be liable under the guarantees only if the losses in the 'pool' exceeded the amount of mortgage insurance fees collected on the projects (after an allowance for administration costs, etc.). The specifics of the arrangement would, of course, need to be determined through negotiation with CMHC. Pool insurance is already a common approach used in commercial MBS securitization.

Form a Provincial Mortgage Insurance Operation

Another option available to the Province would be to replicate CMHC's mortgage insurance function through a Provincial mortgage insurance corporation. For the Province to offer mortgage insurance would require the acquisition of staff experienced in underwriting rental financing and establishing a fund similar to CMHC's Mortgage Insurance Fund to finance losses which would result from future loan defaults. This would be a significant undertaking – the staff skills required are not common; the potential risks of loan defaults are substantial; and competing with CMHC for rental insurance business could be difficult. With its federal government guarantee, CMHC would probably be the first choice for most potential rental investors, and it is

¹⁵ There are precedents for such arrangements. When the Province was funding unilateral social housing programs in the late 1980s and early 1990s, arrangements were made with CMHC to provide mortgage insurance for loans equivalent to 100% of the costs of these projects, without charging a mortgage insurance fee. The Province provided CMHC with guarantees that all losses would be covered by the Province in the event of any project default.

likely that they would retain the lion's share of the low-risk (low LTV) loans which bolster mortgage insurance fee income without adding much to the risk exposure of CMHC's Mortgage Insurance Fund.

For the most part, the Provincial mortgage insurance corporation would be competing for the business of potential rental investments which could not secure adequate financing from CMHC – almost certainly, these would be higher-risk projects which CMHC would probably prefer not to underwrite – a problem of adverse selection which creates excessive risk characteristics for the insurance pool. To the extent that much (if not most) of the Provincial mortgage insurance corporation's business consisted of these higher-risk loans, the Province would be exposed to potentially very significant losses in the event of a major downturn in the rental market – without the balance of lower-risk projects.

On the other hand, if a Provincial mortgage insurance corporation was able to secure a significant share of the low-risk rental loans in competition with CMHC, there is nothing which would prevent CMHC from adjusting its operations and fees to be more competitive. With its national mandate, nationally diversified risk, the solid financial position of the Mortgage Insurance Fund, profitable stream of fees from homeownership loans (although CMHC claims that under commercialization it is not permitted to cross subsidize between insurance lines) and established relationships with all major financial institutions in Canada, CMHC could certainly be a formidable competitor if the new Provincial mortgage insurance corporation began to attract some of its core business.

Establishing a Provincial mortgage insurance corporation in competition with CMHC is considered the least desirable option for the Province. Pressing for further flexibility from CMHC, partnering with the federal government, or working with private sector financial institutions to facilitate easier access to mortgage financing would all appear to offer greater potential (and more manageable risks) than attempting to compete directly with CMHC.

Explore Private Sector Alternatives to CMHC Mortgage Insurance

The discussion in Section 5 regarding US practices in financing rental housing suggests that there may be alternatives which offer potential for financing which might be a reasonable alternative to CMHC mortgage insurance – or, at least, more favourable financing terms than are currently available through conventional financing. The financial community is very innovative, there are a number of options which might offer attractive alternatives to CMHC mortgage insurance – especially if the Province is willing to play a supporting role.

One option would be a partnership with mortgage insurance offered by GE Capital Mortgage Insurance Canada (GEMICO). GEMICO has not to date been involved in mortgage insurance on rental properties – and, notably, their US parent has also avoided this area. This suggests that there may be issues related to starting up such a new product line (e.g. problems of adverse selection with CMHC taking the bulk of low-risk loans) as well as a perceived lack of profitability in this type of business. However, as discussed above in relation to a potential Provincial partnership with CMHC, there may be an opportunity to explore a risk-sharing

partnership with GEMICO. A partnership between the Province and GEMICO whereby the Province offered some guarantee to limit GEMICO's risk exposure (e.g. a stop-loss guarantee above some level acceptable to GEMICO) could provide an alternative means of facilitating competition for mortgage insurance for rental investors.

Another issue with respect to private mortgage insurance is that GEMICO-insured mortgages might not attract quite as favourable an interest rate from lenders as CMHC mortgage insurance, since CMHC-insured mortgages enjoy a 100% guarantee by the federal government, whereas the government guarantees 90% of the liabilities of GEMICO. According to a submission by GEMICO to the Standing Committee considering amendments to the *National Housing Act*:

"Under Bank of International Settlement rules, lenders keep zero capital in reserve when a loan is insured with CMHC but must keep \$400 of capital for every \$100,000 of mortgages insured by the private insurer. The capital cost differential has resulted in several lenders indicating that, going forward, they will be forced to limit or curtail their purchases of mortgage insurance from GEMICO despite receiving outstanding service."¹⁶

Because of the additional capital requirements associated with GEMICO-insured mortgages, the mortgage interest rates on such mortgages would be somewhat higher than the comparable CMHC product – a disadvantage given the importance of mortgage financing in terms of the economics of rental investment. This might be something that could be addressed in the partnership arrangements between GEMICO and the Province. In any case, borrowers and lenders might be willing to deal with this spread issue if the process of obtaining approvals is more streamlined than the CMHC alternative.

Another option for the Province is to examine alternative financing arrangements for rental housing – i.e. financing arrangements whereby mortgage insurance is replaced by (or supplemented with) other forms of credit enhancement. There are numerous innovative financing arrangements in the US which might have application in Canada. Conduits and increased use of mezzanine financing (essentially second mortgages on top of an insured, or conventional, first mortgage) are alternatives that might be explored with major financial institutions. The Province might have a role in providing guarantees for part of the financing (e.g. the second mortgage) which could be combined as a subordinate loan with insured or conventional loans.

Therefore, if the Province concludes that obtaining adequate financing continues to be a problem for new rental investors, and if a partnership arrangement with CMHC is not considered to be workable, arrangements could likely be made with other financial institutions to expand the range of financing opportunities available to rental developers – through the use of a Provincial guarantee for all (or part) of the financing available. Announcement of a willingness on the part of the Province to accept some of the potential risk in financing new rental projects would likely result in a variety of proposals from the private sector which would help to 'flesh out' the options available to the Province.

¹⁶ Notes for a Statement by Mr. Peter Vukanovich, President, GE Capital Mortgage Insurance Canada, to the Standing Committee on Natural Resources and Government Operations, re *Bill C-66: An Act to Amend the National Housing Act and the Canada Mortgage and Housing Corporation Act*, April 13, 1999, page 5.

7. **Conclusions**

CMHC mortgage insurance is a key element in securing financing for new rental development. This report has explored the recent changes to CMHC's mortgage insurance fee structure and related underwriting criteria. In addition, it has investigated rental lending practices in the US and explored possible alternatives whereby the Province might assist in promoting improved access to financing for rental projects.

Key stakeholders, including lenders and potential investors, view CMHC mortgage insurance with mixed feelings. On the one hand, CMHC insurance provides access to high-ratio financing, lower interest rates and greater leverage than would otherwise be possible. At the same time, the process and associated negotiations are seen as excessively lengthy, opaque and frustrating. Stakeholders would like to see a more streamlined process and greater degree of flexibility in CMHC's underwriting practices – and lower fees.

While the recent changes in CMHC's mortgage insurance practices appear on the surface to have a beneficial impact on new rental housing financing, the analysis here indicates that these benefits may be temporary – it appears that the changes could, over the long-term (with rising interest rates), actually reduce the level of financing available for new rental projects.

If the Province considers that the changes in CMHC's mortgage insurance practices are not sufficient to facilitate access to mortgage financing for rental development, a number of options are available:

- Continue to press the federal government for more flexible financing terms for rental development;
- Partner with the federal government to provide improved service (by sharing risk);
- Form a Provincial mortgage insurance operation; or
- Promote private sector alternatives to CMHC mortgage insurance.

Of these options, the first two appear most feasible.

Pressing for more flexible financing terms for rental development could take several avenues:

- **Analysis of the risks of rental mortgages** – without access to CMHC's actuarial analysis, it is not possible to undertake a comprehensive assessment in this area. However, a review of the package of risk mitigation measures employed by CMHC (substantial mortgage insurance fees, strict underwriting criteria, rental achievement holdbacks, and guarantees from investors) suggests that there may be a case for some flexibility whereby if CMHC has adequate security (e.g. the project itself and 'iron-clad' guarantees), perhaps some of the other risk mitigation measures (e.g. DCR or fees) might be relaxed to some extent.
- **CMHC's mandate** – stakeholders question why CMHC's mortgage insurance functions should be retained in a crown corporation if the Corporation is unwilling to promote the broader public policy goal of facilitating rental investment by taking on more risk. Given

the evident profitability of CMHC's mortgage insurance operations, and the lack of new CMHC-insured rental housing loans, there would seem to be some room to manoeuvre by taking greater risks on rental mortgage insurance.

- **The Bank Act** – at present, federally chartered lenders are not allowed to make property loans in excess of 75% of property value without mortgage insurance. With no competition, this means that CMHC is the only option available for borrowers seeking high-ratio loans. In the US, lenders regularly provide financing equivalent to 80% of property value without mortgage insurance. It may be time to revisit this requirement and allow lenders to take on the additional risk associated with high-ratio loans without requiring mortgage insurance. This would permit the market to price risk and would provide an alternative risk assessment to that undertaken by CMHC.

Alternatively, the Province could negotiate a risk-sharing partnership with the federal government to facilitate improved access to mortgage insurance for new rental projects. The partnership could utilize CMHC's existing underwriting infrastructure and expertise to provide a sound basis for the risk assessment of rental projects but, at the same time, create the opportunities for additional flexibility on maximum loan levels and/or lower fees – through Provincial guarantees.

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